

# THE RICHBÄCHER LETTER

*Monthly Analysis of Currencies and Credit Markets*

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**It looks as if we were suffering from an overproduction of debt, not overproduction of goods.**

*Freeman Tilden, A World in Debt*  
Funk and Wagnalls, New York, 1936

## What Miracle?

Posing this question, the only economy that comes to mind is, of course, the American economy. There, and only there, do many people perceive an economic miracle. As reported in the last letter, credit creation spun completely out of control in the United States last year, especially in the fourth quarter. In this issue, we have to report and to warn monetary development has dramatically reversed since the start of this year. Credit and money growth have plunged with a vengeance.

Yet there seems to be no end to the good news about the American economy. Most relevant has been soaring productivity growth, running recently at an annual rate of close to 3%, compared to barely 1% for more than two decades. Has the long-awaited payback from the technology binge finally arrived? Must we revise our critical view of the U.S. economy as a grossly unbalanced and, therefore, highly vulnerable bubble economy, waiting for the needle that will prick it?

We see no reason to change our critical view. What we actually observe behind the facade of the booming economy are unsustainable imbalances going to ever-greater excesses. The most ominous of them is poor profit performance, blatantly defying the boom conditions. Moreover, a systematic investigation of the actual forces at work bodes worse to come.

Above all, we have taken a hard look at the widely hailed "new paradigm" achievements of the U.S. economy. Sometimes it is necessary to step back in order to see the forest. Though we had a hunch what we would find, the effective findings stunned us, vividly reminding us of the old saying about the progression of lies: Lies, damned lies, statistics.

## WHAT PROFITS?

Bearing in mind that profits are the lifeblood of capitalist economies, we have focused for more than two years on the U.S. economy's oddly deteriorating profit performance. This holds true even though it is an open secret that corporate management and Wall Street analysts are unabashedly conspiring to push stock prices by "managing" earnings per share to levels that please the market.

Trying to keep track of the profit trend, we have fixed on weekly reported earnings per share for various index groups, as published in Barron's. They are found within a comprehensive table "Indexes' P/Es & Yields," which lists valuation measures for several stock indexes. Compared to a year ago, profits per share on the S&P 500 have declined from \$39.72 to \$37.71 and on the S&P Industrial index from \$42.13 to \$38.37. Since stock prices have nevertheless soared during this period, the P/E ratio for the first group has skyrocketed from 28.22 to 35.41 and for the second one from 30.96 to 41.58.

For a booming economy, these profit figures are appalling, especially since they are heavily "managed" to the upside. For example, IBM's net income in 1998 increased 4% from 1997, but with huge stock buybacks, management boosted the rise per share to almost 10% year-over-year. While Wall Street continues to exult at "impressive EPS growth" as justification for the historically extreme valuations, the dismal reality is a lousy profit trend.

Completely obscuring the profit picture, Wall Street analysts have invented so-called operating earnings, which habitually look much better. According to a tabulation by *The Wall Street Journal* for 665 of the companies that make up the U.S. component of the Dow Jones Global Indexes, *reported* corporate earnings declined 4% in the first quarter of 1999, compared with the year earlier quarter. But operating income rose a strong 9.6%. Reported income of consumer cyclicals fell 45%, while operating income posted a 15% gain.

What's the difference between the two profit measures? Reported earnings include the extraordinary write-offs generally related to corporate restructuring. Operating earnings exclude not only the write-offs but also interest expenses. Look at General Motors as an example. For 1998, operating income was \$6.5 billion, up a sensational 80% from 1997. But interest expense, left out of account in this calculation, was almost \$7 billion. Given in addition big write-offs due to the strike, reported net income was about \$ 3 billion, less than half that of 1997. This is a great example of how management and Wall Street manipulated a very poor year for General Motors into an excellent year.

Wall Street reasons against *reported* earnings that the inherently wide swings in the nonrecurring write-offs tend to mask the underlying trend in profitability. Considering, though, that in the wake of merger and acquisition mania such write-offs are recurring with impressive regularity and in sizable magnitude, this practice to take them out of the profit calculation essentially ensures a permanent, appreciable overstatement. Even if this practice may makes sense, when looking at individual companies, these write-offs are definitely a recurring feature, when looking at the economy as a whole.

What's more, investors are deliberately lulled into the comforting belief that these write-offs should be seen in a positive light as tangible sign of impending drastic, profit-enhancing restructuring action. Which, actually, is not such a sure thing as the firms want to make investors believe. Compounding the deception, in any case, is that these write-offs are regularly padded with future expenses, a nice trick to puff up future earnings and to hype stock prices.

## **EMPLOYEE STOCK OPTIONS REVISITED**

Yet these and various other manipulative accounting tricks are peanuts in comparison to the practice of hyping corporate earnings through the proliferating issuance of employee stock options. The beauty of this device is that it lowers the wage bill that is charged as labor cost expense to the corporate profit and loss accounts, which implicitly boosts corporate profits. In the same vein, stock options importantly help to pacify the "inflation hawks" in the Federal Reserve and elsewhere because the gains to employees from such options do not enter the government's employment cost index.

Last but not least, these stock options are largely responsible for the unprecedented windfall in the way of higher personal taxes for the government. They have also become great collateral to borrow against. Wall Street firms have become banks for lending to corporate executives against the collateral of stock options. This conveniently keeps insiders from having to sell their securities to build their mansions.

While the distorting effects of employee stock options on profits are common knowledge among market experts and policymakers, this issue is generally treated with silence, for an obvious reason. Its disclosure would devastate the bull story of an American profit miracle. Only Mr. Warren Buffet among the notables has complained. The only one to make precise calculations about their effects on profits, is Mr. Andrew Smithers of Smithers & Co. Ltd., a research institute in London.

According to his research, if corporations had fully and properly accounted for the costs of the stock options they granted but did not expense in accordance with current accounting guidelines, their aggregate published profits would have been lower by a whopping 56% in 1997 and 50% in 1998. This monstrous overstatement of

profits implies, of course, vastly higher price-earnings ratios than those currently calculated. Adjusted for the cost of stock options, the S&P had a P/E ratio of nearly 55 at the end of 1997 and of 63 at the end of 1998.

These are shocking numbers. However, it must be realized that this grotesque incongruity between distributed stock options and total corporate profits primarily reflects the prodigal distribution of options. Involving no charge to corporate earnings as well as fragmentary information to shareholders, management has been handing out such options like confetti. Absent these advantages, this practice would undoubtedly shrink radically, and with it the implicit boost in profits. At any rate, we must regard profits as grossly overstated.

The remarkable thing is that despite such massive manipulation, profits have gone nowhere since the third quarter of 1997. This is clearly grossly at odds with the prevailing perception that superior American managerial skill and huge high-tech investments have been working growth and productivity miracles on the U.S. economy in recent years.

### **TRACING PROFIT PROSPECTS**

True, the current U.S. business cycle started with strong, above-trend profit growth in 1992-94. But as we have repeatedly explained, this early profit surge was produced by some temporary factors that had nothing to do with any productivity miracle. The single main cause was a one-time plunge in interest costs. Over the whole course of the cycle, profit growth has at best been in step with previous cyclical recoveries. Oddly, it turned distinctly sluggish as early as 1995, just when the economy embarked on its “phenomenal” growth performance in this cycle. Strictly speaking, it became a profitless boom.

This profit weakness, which by the way commenced well before the outbreak of the Asian crisis, has now lasted long enough to be taken seriously and to impose the need to explore its underlying causes. Bearing in mind the crucial role of profits in stimulating business investment, this is, for sure, the most important question to be addressed and carefully investigated at this juncture, with the further question in mind, whether recent and current developments in the U.S. economy actually portend profit improvement or deterioration in the longer run.

Preferably, Wall Street simply ignores the profit malaise. Tentative explanations vary from a temporary negative influence of the Asian crisis to a squeeze from rising labor costs and lack of pricing power. Considering the profit malaise, against the backdrop of a booming economy and recently surging productivity gains, however, neither explanation appears satisfactory. Principally, the mere comparison of relative movements in costs and prices is much too simplistic. The most critical macroeconomic influences on business profits, such as changes in the trade balance and in capital spending, are not at all captured by the cost and price curves.

First, however, we should observe a most important clarification: It is aggregate profits that are at issue—essentially the profits of the business sector as a whole and the influences impacting them, and this implies a macroeconomic perspective. Aggregate profits are generated by specific macroeconomic flows of funds. Tracing these flows begins with the simple realization that profits, by definition, equal business revenues in excess of business expenses. The snag is in the identification of those revenues.

In our view, the “flows method” in analyzing “profit sources” offers a compelling and plausible causal explanation why U.S. corporate profits are faring so badly. Yet first a few explanatory remarks about this approach. The “profit equation” in which it culminates first became familiar to us many years ago through writings by and about John Maynard Keynes, to whom this equation is in general ascribed. But its true discoverer was Michal Kalecki, a Polish economist who in the 1930s lived among the Keynesian circle in Cambridge. With reference to this profit equation, he made a famous quip: “Workers spend what they earn and capitalists earn what they spend.”

We give this little bit of history because in the United States this concept is applied and propagated today

by the Jerome Levy Economics Institute of Bard College with the claim that an ancestor of the family developed it already in the year 1914. In any case, the Institute has done an excellent job in working out the subtleties of this analytical device. In our view, this method that provides invaluable insights into the dynamics at work in our economies and into the process of profit generation.

### **THE FALLACY OF COMPOSITION**

In particular, this approach is extremely helpful in exposing popular misconceptions arising from the frequent failure to distinguish between a microeconomic and a macroeconomic perspective. Microeconomics studies the impact of certain measures and influences on individual companies or industries, while macroeconomics is concerned with effects on the economy as a whole. The differences between the two perspectives are most important, yet the most neglected aspects in economics.

Among economists, this failure to distinguish between the two perspectives used to be known as the “fallacy of composition.” It says that what befits a single firm is not necessarily favorable for the economy as a whole. If one firm cuts wages, it is able, *ceteris paribus*, to expand output; but it is wrong to assume that wage cuts act equally upon aggregate profits. Once businesses throughout the economy follow suit, it won’t work in the same way because wages are, at the same time, the purchasing power which buys the goods and services that the business sector produces and wants to sell. Wage cuts across the whole economy reduce business revenues as well as costs. Downsizing aggregate payrolls curtails business expense which curtails personal income which curtails personal spending on goods and services which, after all, curtails business revenue and profits.

In reality, there is no simple relationship between changes in wages and changes in profits. What happens to total business profits, depends in the last analysis upon indirect consequences of corporate downsizing, wage rises or other changes in aggregates in the economy, such as business investment, personal saving, and foreign trade. As we shall explain later in this letter, widespread corporate downsizing as such—cutting payrolls and capital spending, for example—tends to reduce overall business profits by reducing business revenues. In short, from the macroeconomic perspective, downsizing is inexorably self-defeating.

### **THE FOUR PROFIT SOURCES**

Wanting to trace the flows of money that wind up as business profits, we have to divide the economy into four sectors: businesses, private households, government, and foreign sector. Our focus is on net spending flows into the business sector as the crucial determinants of aggregate business revenue. In other words, these specific flows are the actual profit sources. Changes in these flows cause equal changes in profits.

Profit-relevant flows of funds are the following: (1) business net capital spending, (2) foreign trade, (3) personal saving, and (4) government deficits. These four components of the profit equation warrant separate consideration. For reasons that will become apparent later, we have to look at these flows both in nominal and in real terms, that is, in chained and in current dollars.

### **WHAT CAPITAL SPENDING BOOM?**

There are various kinds of investment spending: inventories, equipment, structures, and residential building. Together, they are the key to the business cycle and to profit generation. The emphasis here is on the role of investment spending in creating business sector revenue, not upon its second role as major determinant of capacity and productivity growth. All such investment spending sets flows of funds in motion that become profits.

Indeed, they cause them. They have one decisive feature in common — they create business revenue without generating business expenses.

When a firm acquires a machine or a building, it exchanges one asset (owned or borrowed cash) for another, a tangible asset. But in the profit and loss account, this act of capital spending does not involve an immediate expense until the first depreciation charge is recorded. The capital goods being installed are created and sold by a group of firms in the business sector itself. For them, the money paid by the purchaser of the capital goods generates an equal amount of revenue.

Now to the macroeconomic perspective: The crucial point is that all kinds of investment spending produce correspondingly higher revenue for the business sector as a whole but—for the reason explained—no immediate expense. This is what normally makes investment spending the business sector's most important profit source, provided there is strong investment spending.

But although investment spending causes no expense when it occurs, it is eventually expensed in full through depreciation charges distributed over the asset's lifetime. These charges, accordingly, diminish business profits. Given the depreciation charges on existing fixed assets, it is in fact net investment, not gross investment, that counts for the current profit generation. Bearing these crucial interrelationships in mind, we come to the great puzzle and the great paradox in the U.S. economy during the last years: a profitless investment and productivity boom.

The puzzle's solution lies in two numbers, both contained in the above table, and both concerning the contribution of the computer industry to GDP growth. Strictly speaking, it lies in the phenomenal difference between the two different yardsticks, by which this is measured in the GDP accounts: \$ 5.4 billion in current dollars versus \$ 146 billion in chained dollars.

In current dollars, the business sector increased its net investment on computers in the 12 months through the first quarter of 1999, from \$91.8 billion to \$97.8 billion, or a paltry \$5.4 billion, accounting for 1.3% of nominal GDP growth. But in the fanciful statistics of chained dollars, the gauge for real GDP growth, reflecting the government's view of how much computational power has been added to the existing stock of computers, this financial bagatelle translated into a mammoth addition of computer processing power—from \$292.2 billion to \$438.2 billion, up by a stunning \$ 146 billion, accounting for 49% of real GDP growth during this period.

#### GROSS DOMESTIC PRODUCT (GDP), CHAINED DOLLARS

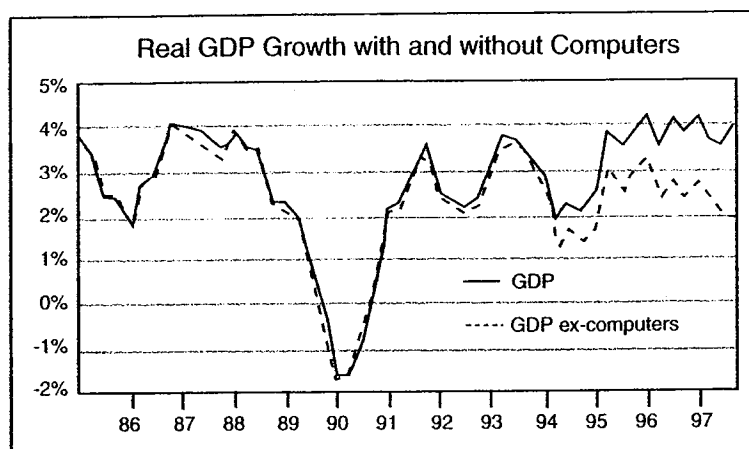
				CONTRIBUTION TO GDP GROWTH
GDP	7.762.5	7.464.7	+ 297.8	
Personal consumption	5.331.9	5.055.1	+ 276.8	92.9%
Fixed investment	1.342.4	1.224.9	+117.5	39.4%
Non-residential	1.010.3	931.9	+ 78.4	26.3%
Producer durables	821.7	738.8	+ 82.9	27.8%
Information	443.0	353.4	+ 89.6	30.0%
Computers	438.0	292.2	+ 146.0	49.0%
Industrial equipment	130.9	131.5	- 0.6	
Residential investment	336.1	298.5	+ 36.6	12.3%
Net Exports	- 305.6	- 198.5	- 107.1	- 36.0%

#### GROSS DOMESTIC PRODUCT (GDP) CURRENT DOLLARS

				CONTRIBUTION TO GDP GROWTH
GDP	8.807.9	8.384.2	+ 423.7	
Personal consumption	6.047.1	5.676.5	+ 379.6	89.6%
Fixed investment	1.375.1	1.271.1	104.0	24.5%
Non-residential	970.8	921.3	+ 49.5	11.7%
Producer durables	719.6	676.3	+ 43.3	10.2%
Information	244.7	226.5	+ 18.2	4.3%
Computers	97.2	91.8	+ 5.4	1.3%
Industrial equipment	145.7	145.4	+ 0.3	
Residential investment	404.3	349.8	+ 54.5	12.9%
Net exports	- 198.6	- 123.	- 75.9	- 17.9%

Source: Survey of Current Business, Department of Commerce

The following chart illustrates the phenomenal impact of the latter on measured GDP growth.



Speaking of economic growth, the focus is always exclusively on growth in real terms. What matters from this perspective in the United States' case is the explosive rise in computer processing power by \$146 billion, as measured in chained dollars. But owing to the dizzying fall in the prices of computer equipment, this involved just a paltry increase of \$ 5.4 billion in spending in current dollars. Which of the two gauges counts for profit generation should be clear: current dollars, not phantom "chained" dollars, a measure of spending that never took place.

Over the three years 1996–98, U.S. GDP rose by \$810 billion altogether in chained dollars, or 4% annually (see chart). Of this total, a stunning share of \$310 billion, or 38%, accrued from investment in computer power. Taking the computer component out of the GDP accounting, the large rest of the economy really had an annual growth rate of 2.5%. Last year, it was just 2%. See above chart.

### **MAKING ALL THE DIFFERENCE**

What this means is clear: The U.S. economy's recent brilliant performance—its buoyant growth and falling inflation rates—vanishes into thin air. With barely 4% of the total workforce and plunging prices, it accounted last year for virtually 50% of GDP growth in chained dollars. Outside the computer industry, about 95% of the workforce produced the other half of GDP growth. But what really played the key role in producing the fabulous growth rates in the computer industry's production and thereby in real GDP growth, as earlier mentioned, was the statistical adjustment in 1995 which shifted the measuring of the contribution of computer investment to real GDP growth from volume gains to improvements in processing power.

Clearly, the computer industry makes all the difference to the U.S. economy's statistical performance. If computer output is taken out of the GDP accounting in chained dollars, all of the "new paradigm" luster—strong economic growth, sharply higher productivity gains, and falling inflation rates—dissolves into thin air.

### **SILLY STATISTICS**

We keep wondering how such a large share of information high-tech in real GDP growth is improving the American living standard. You can't eat information. For us, measuring computational power in chained dollars is simply silly statistics. But have the huge investments in information technology-related equipment not markedly raised the output per hour produced by each worker, as the productivity statistics are manifestly showing?

Don't be fooled. Looking for technology-driven productivity gains, it is essential to distinguish between two different sources of the gains that are registered: first, in the computer industry itself from producing computers and, second, across the whole economy from the spreading use of computers. What matters for raising living standards in general is, of course, the latter, nothing but the latter.

The answer to this key question is all too easy. Just compare the computer industry's very small share in

employment with the huge share of its contribution to GDP growth in terms of chained dollars over the past years. It becomes clear that the recorded jump in overall productivity is overwhelmingly attributable, probably fully attributable, to the computer industry itself, that is, to the steep rise in its own output. Substantial productivity gains from the use of the computers installed in the economy as a whole remain as elusive as ever. A professional statistician could easily check this. But who wants to know? We offer a simple, plausible explanation: With computers so cheap, everybody is grossly overinvested in computer power, using generally only a fraction of its potential.

### **RECORD-LOW NET INVESTMENT**

Exploring the pattern of investment spending in the U.S. economy further, we note another apparent paradox: record-high gross investment but record-low net investment. While business fixed investment as a share of real GDP surged to 12.5% in 1998, from the cycle low of 8.9% in 1992, the net growth of the total stock of business productive capital during the 1990s has averaged little more than 2% annually. That is the slowest pace of capital accumulation in the postwar period. The 1960s saw a 4.3% gain in the heyday of the last productivity-led recovery. Moreover, taking the average annual rise in employment by 1.9% during this period into account, capital input per worker is more than anemic, it is minimal. Plainly, these data do not at all support the view that rapid capital accumulation is boosting output or labor productivity growth more strongly than in the past.

The key factor behind this disparity in the growth of gross and net investment is a massive shifting of business capital spending to shorter lived capital goods (computers!). As a result of such a shift, more investment is required to just provide for replacement, making gross investment a deceptive indicator. It is, for example, estimated that more than 60% of annual corporate IT budgets go toward replacement of outdated equipment and product upgrades.

Weighing these figures, please keep in mind that the bulk of the investment boom is in computer power, as measured in chained dollars that were never spent. Capital spending on industrial equipment, that is on *machinery to produce goods*, went nowhere last year. In chained dollars, it even showed a slight decline. As more than 80% of the investment spending on computers is occurring in the service sector, the rate of capital formation in the manufacturing sector has essentially been particularly slow.

### **THE TRADE GAP AS PROFIT KILLER**

We now come to the causes and implications of the huge, chronic U.S. trade gap. Wall Street bulls like to stress its beneficial effect in suppressing domestic inflation and thereby allowing the Fed to maintain monetary looseness. Nobody seems to be aware that the trade gap is the single, biggest profit killer for Corporate America.

The first crucial point to see here is that the excess of payments to foreign producers—as reflected in the current account deficit—is lost to the domestic economy. Not only that, the second crucial point concerns the source of the funds flowing abroad as counterpart to the rising trade gap. Essentially, a large part of the money paying for the import surplus, comes from the wage bill paid by American businesses. To that extent, for the business sector, the soaring trade gap implies expenses that fail to come back as revenue, unlike wages spent at home, which return to the business sector as revenue (less savings). In short, a trade deficit subtracts correspondingly from business revenue and business profits.

Considering that the U.S. current account deficit skyrocketed last year by \$78 billion to \$233.4 billion, it is plainly the chief profit killer at work in the U.S. economy. It is astonishing that it hasn't done much greater damage. We shall see what the powerful opposing positive profit source has been.

Implicitly, such a deficit reflects rampant domestic inflation in the sense that domestic demand expands

faster than the economy is able to supply in increased output. With slow demand growth and considerable underutilized resources in the rest of the world, American overspending, particularly on consumer goods, fueled by excess credit, spills heavily over into soaring imports. A very similar pattern, by the way, occurred during 1982-86.

Yet we suspect, there is more than just domestic spending excesses behind the exploding U.S. trade gap. Remember the lack of investment in industrial equipment. The surge in the trade gap seems to have a further significant cause in the chronic sluggishness of manufacturing investment in equipment for production, which suggests that the deficit has a substantial structural component. In contrast, there has certainly been heavy overspending on investment in office building and hotel construction.

### **WAGES, PERSONAL SAVING, AND PROFITS**

Finally, we come to Corporate America's chief profit source in recent years: manic consumer spending. The critical point is not whether wages rise or fall but whether the gain will be spent or saved. As a rule, the household sector as a whole puts a part of its income aside as savings, reducing to this extent the stream of revenue back to businesses. Dissaving has the opposite effect of boosting business revenue and profits.

Over the last years, growth in domestic demand in the United States has become heavily dependent on dissaving by the consumer. From the first quarter of 1998 to the first quarter of 1999, personal saving plunged from + \$73 billion to - \$30 billion, increasing consumer spending by more than \$100 billion. To put this amount into perspective, it compares with an overall rise in nominal GDP by \$423 billion and a rise in the current account deficit by \$78 billion.

This leaves us with the fourth and last component in the macroeconomic profit equation: the net balance between government expenditures and revenues from taxation. The existing budget surplus implies that the public sector exerts a contractionary influence on the private sector, and eventually on business profits. For the reasons explained, though, we regard the described anomalies in capital spending together with the huge and soaring trade deficit as the chief causes of Corporate America's profit malaise.

### **WHAT IS AILING THE U.S. CREDIT MARKETS? INFLATION OR LEVERAGE?**

In the last letter, we described the credit orgy that Mr. Greenspan unleashed with his rate cuts last September and October. Principally, a financial system is supposed to allocate savings among competing borrowers. The emphasis is on savings as the one and only source of non-inflationary credit. America's financial system has always been the most efficient one in the world in creating vast flows of credit with a minimum of domestic savings. But the financial excesses that happened last year, dwarf anything in history. American policymakers appear to believe that there is no limit to credit expansion, as long as price inflation remains low. Economists have known better for more than 200 years.

Inarguably, 1998 was an historic year for the U.S. credit system. Nonfinancial debt swelled \$953 billion, or almost 30% from 1997. With the Federal government actually paying down debt, the household and corporate sectors more than took up the slack. Net additional household mortgage debt of \$369 billion compared to \$237 billion in 1997, and corporate borrowings surged \$343 billion versus \$258 in 1997.

These two instances of credit excess, however, pale in comparison to the U.S. financial sector's borrowing \$ 1.1 trillion binge, up from \$653 billion 1997. Total system debt, non-financial and financial, increased an astonishing \$2.07 trillion in 1998, versus \$1.36 trillion in 1997. During last year's fourth quarter, bank credit expanded at a 40% annual rate and broad money (M3) grew \$188 billion.



With the collapse in mortgage rates, a spectacular mortgage refinancing boom, especially in 1998's second half, became an unprecedented credit bonanza. In all, more than \$1.5 trillion of new mortgages were created during the year, with almost \$1 trillion of these refinancings. Estimates have the average borrower drawing \$15,000 in cash through refinancing. Essentially, this flood of money made its way straight back into the financial system. Certainly, it was the major source for the more than \$ 200 billion increase in money market funds during the second half of last year. For all of 1998, money market fund assets grew by \$302 billion, compared to \$165 billion in 1997. Last year, broad money (M3) ballooned a stunning \$ 645 billion, compared to \$440 billion during 1997. This borrowing and lending binge acquired manic dimensions. The most egregious example was the \$220 billion growth last year in the balance sheets of Fannie Mae and Freddie Mac balance, almost four times their expansion—\$ 61 billion—in 1997.

Considering these credit numbers, it is obvious that the Fed grossly misjudged the monetary situation when it cut its interest rate three times in six weeks. Although the potential collapse of the overleveraged speculative community brought the financial system to the brink, this specific turmoil was happening against the backdrop of a virtual overall credit explosion. With its panicked reaction, the Fed clearly threw gas on a blazing financial system and economy. Plainly, it gave the American credit system, already expanding out of control, a powerful new push.

## **TWO GAMES IN TOWN**

As to the consumer's spending spree, there were really two games in town—the wealth effects from the stock market boom and the income effects from the mortgage refinancing boom. It appears that the latter was the more important. In addition to boosting consumer incomes, it boosted the whole financial system. Above all, it proved a convenient mechanism to transfer mortgage securities away from the impaired leveraged speculating community (mainly hedge funds and Wall Street firms) and onto the balance sheets of Fannie Mae and Freddie Mac.

What's more, through Freddie and Fannie, the Fed provided one fantastic opportunity to the American homeowner. In October, conventional 30-year mortgage rates had averaged 6.5%, the lowest levels since 1968. Rates today are 7.2%. And, according to Freddie Mac, 48% of homeowners refinanced into loans of at least 5% higher than the original mortgage. According to Freddie Mac, "Compared to previous refinancing booms, such as the one in 1993, more borrowers are taking advantage of the stronger housing market to take out accumulated equity. The average refinanced home in 1998 had appreciated 10%, while in 1993 (the previous record refinancing boom) the value of refinanced properties had on average grown by only 2%."

This, importantly, is the most unappreciated anomaly from last year: Sharply rising home prices and record low mortgage rates in combination with aggressive lenders offered private households a once-in-the lifetime opportunity to translate property appreciation into hard cash and lower debt-service payments by refinancing their mortgages at lower rates. Numerous homeowners were quick to take the cash, play the stock market and binge on consumption. Never before has there been such a blatant episode of financial and economic bubble excess.

To finance this historic credit boom, Fannie and Freddie aggressively tapped the money market, borrowing short-term in their massive leveraging of mortgage securities. Of the \$220 billion in balance sheet growth in 1998, \$139 billion, or 63%, was financed by an increase in short-term debt. With their frenetic buying of residential mortgages and other credit market instruments and their heavy short-term financing, the two institutions provided desperately needed liquidity to a distressed market place by specifically limiting the issuance of longer-term securities. And, of course, the Fed's rate cuts to 4.75% made this domestic carry trade even more attractive. By the end of 1998, Fannie and Freddie had combined short-term borrowings of \$ 400 billion, a staggering increase of 53% from the previous year.

But it was not only Fannie and Freddie that took full advantage of the Federal Reserve's extraordinary accommodation. The private financial sector ended 1998 with \$907 billion of open market borrowings, a 22% increase from the previous year. And, according to Federal Reserve data, the non-financial sector increased short-term debt growth by \$193 billion, or 14%. General Electric expanded short-term debt 23% in 1998, to \$117 billion. Wall Street balance sheets grew flush with short-term liabilities financing huge security inventories. And for an additional proxy of the growth in short-term borrowings, money market fund assets have grown \$265 billion the past year, now approaching \$1.45 trillion.

For many borrowers, and clearly for Fannie Mae and Freddie Mac, heavy dependence on short-term borrowings goes hand in hand with heavy use of derivatives. Fannie Mae ended 1998 with \$170 billion of derivative positions. This, however, pales in comparison to Freddie Mac with \$313 billion, including \$220 billion of futures and options, and \$42 billion of interest rate swaps. So, for these institutions, the strategy is to leverage 30:1 in mortgages, financed about 50% with short-term money, while relying on derivative products for interest rate protection.

In past letters we have in some detail stated our view of the momentous fallacy in the widespread use of derivatives as a form of insurance. Certainly they can insure individual market participants against specific risk, but not investors as a whole. A general rise in interest rates or a stock market crash are a systemic risk, affects all insured portfolios at once, given the fact that the prices of securities around the globe are highly correlated. That's the fundamental difference to the insurance of houses against fire. Insurance against a major move in securities, in short, is essentially illusory, while the risk that 30-40% of insured houses will suddenly burn down, is non-existent.

What's more, as we have also repeatedly explained, the widespread use of derivatives is a sure recipe for disaster because by offering investors an insurance that is worthless in the case of a large-scale shift in the markets, it has massively spurred risk-taking by financial leveraging. Consider: Nearly 50% of Treasury bond holdings are subject to repurchase agreements. In other words, they have been "hocked" in exchange for credit.

In this regard, one only has to remember back to 1994. This debacle entailed a wrenching period with huge losses and even bankruptcy for the hedge fund community, after it had aggressively speculated in the infamous leveraged "carry trade." Beginning in 1989, the Fed reduced rates 23 times in less than three years, reaching a low of 3% in 1992. And the Fed-induced extraordinarily steep yield curve was much a gift for the hedge fund community, Wall Street firms, and derivative players, as well as the targeted beneficiary, the impaired U.S. banking system.

Yet, when the Fed reversed course with its 25-basis-point rate increase in February of 1994, the system quickly fell under considerable stress. Gross leverage and speculative excess had developed throughout the government securities markets. What's more, the bubble excesses in U.S. credit markets had fostered similar bubbles in emerging debt markets. When the U.S. bond market was routed, the forced unwinding of huge leveraged bets in Latin debt markets, particularly in Mexico, proved catastrophic. The reversal in Federal Reserve accommodation and the ensuing deleveraging was the catalyst for the Mexican collapse, followed quickly with a U.S. Treasury and Federal Reserve bailout.

When rates rose, however, many of these derivative products proved nothing more than reckless leverage with sizable losses for many and bankruptcy for Orange County. Few had recognized the incredible credit excesses that had developed. In early 1994, with yields on 2-year Treasuries at about 4% and the 30-year bond trading at about 6.2%, few foresaw that by May these rates would go to 6.2% and 7.6%. In November of 1994 the long-bond yield surpassed 8%. Rising rates set in motion a self-feeding process of deleveraging, forcing speculators to dump securities and the derivative players to both hedge exposure and unwind positions. With

this fiasco in mind, all we can say is that the degree of leverage and speculation in the system today makes 1994 look like "child's play."

### **DRAMATIC REVERSAL**

In watching current monetary development, we note quite a dramatic slowdown in money and credit growth since the beginning of the year. After growing at a 13% rate during the fourth quarter, M3 has expanded less than 5% thus far in 1999. Through the end of April, money market fund assets expanded \$70 billion, 15% annualized. This compares to money fund asset growth of \$108 billion, or a rate of 26%, during the final four months of 1998. During the height of the mortgage refinancing boom, the five months from early July through early December, money market assets exploded by almost \$ 220 billion.

And for the first four months of this year, bank credit has actually contracted \$ 60 billion, or at about a 4% annualized rate. About half, or \$ 30 billion, of this decline is explained by a contraction in lending for security purchases. Additionally, commercial banks have reduced holdings of securities by \$ 40 billion. But it is not only security credit that has slowed. Commercial and industrial loans have grown at 1% annualized rate. Consumer loans have been flat. Real estate lending has drastically slowed from a growth rate of 12% to 7% so far this year. Total non-financial debt expanded \$ 219 billion, after \$ 265 billion during the fourth quarter. Broad money (M3) grew \$ 93 billion, or at a 5% rate, during the first four months of this year, after growing \$ 251 billion, or 13% during the final four months of last year. During the last 13-week period, M3 growth slowed further to 3%.

With interest rates surging, mortgage rates have moved to the highest levels in more than 18 months. Mortgage refinancing volume has collapsed to about 15% of levels from last fall. Freddie Mac, after expanding assets by \$91 billion, or at a rate of 88%, during 1998's second half, grew assets by \$6 billion, or at a 7% rate, during the first quarter. Fannie Mae increased assets by \$ 56 billion during 1998's second half, or 26% annualized. During 1999's first quarter, Fannie Mae expanded assets \$ 16 billion, or at a 13% rate.

So, from bank credit to Fannie and Freddie balance sheets, credit growth has plunged. Not only have higher rates virtually ended the refinancing boom, they have also hit the leveraged speculating community, forcing them to liquidate positions. And while we do foresee more deleveraging from the speculators, we actually regard derivatives as the greater risk going forward.

Many companies had been borrowing with the expectation of "swapping" into longer-term fixed financing come a change in the rate environment. Fannie Mae and Freddie Mac have about \$400 billion of short-term borrowings that are financing long-term mortgages. Granted, they do "hedge," however, is not the end of the story. These hedges simply shift the risk to Wall Street. But thinly capitalized Wall Street firms that take these Fannie Mae and Freddie Mac hedges are already heavily exposed to interest rate risk with huge positions on their account. They simply lack the capital to absorb potential losses from a major move in interest rates. That is, they have to hedge themselves against loss by "dynamic hedging" strategies that only exacerbate the general selling pressure. One thing is for sure: Last year's incredible gift of record low mortgages to the household sector is today's incredible loss for the financial sector.

Increasing signs of systemic stress are, actually, developing throughout the U.S. credit markets. Long-bond yields, down to 5.05% in January, recently surged to 5.92%. More indicative of developing trouble, however, are five and 10-year Treasuries yields of 5.57% and 5.66, up 100 basis points from a year earlier. Various spreads have also dramatically widened. Most noteworthy is the 174 basis point widening of emerging market debt instruments. Latin American debt spreads even widened 240 basis points in the worst week since January's Brazilian real collapse.

All in all, this is a pretty heavy turbulence. But given the stock market's resilience, if not buoyancy, it has

so far attracted limited attention. Moreover, Wall Street likes to believe that it is an overreaction to the recent unexpected jump in the consumer price index and also to the improving prospects of a global recovery that may induce the Fed to a belated rate hike. In our view, this sharp rise in medium-term rates demonstrates more than anything else that the U.S. financial markets are a house of cards, built on nothing but the most extreme leverage that the world has ever seen. In a truly healthy market, such a trivial event or such vague expectations could not have such a tremendous, instant impact.

## CONCLUSIONS:

The American "economic miracle" of the last few years stems from two major developments: (1) drunken use of credit by consumers, businesses and speculators; (2) a queer statistical adjustment in measuring the contributions of computer output and investment to GDP growth in chained dollars. All the talk of a "new paradigm" economy is complete nonsense. There is more leverage and more risk in the U.S. financial markets than ever before, including 1929.

The stock market bulls counting on their belief that the Fed wouldn't dare tighten for fear of sending the financial house of cards tumbling. We agree, the Fed is hampered, but we disagree that this infallibly ensures excess liquidity and a booming market forever. The problem is that existing leverage is not enough to sustain the boom. It needs infinitely more and more of the same.

Numerous interest rate cuts around the world since the financial crisis in the autumn of last year and the perception that the central banks are flooding the world with liquidity have been cheering stock markets and forecasters. It is necessary to keep a critical eye on the drastic monetary reversal in the United States.

There is a strong opinion in the markets that the only risk for the U.S. economy is in a possible overheating, with a return of inflationary expectations requiring higher interest rates. The real menace, however, is in the unprecedented magnitude of economic imbalances and speculative excesses.

As to currencies, we can only repeat our consistent statements: With the huge trade gap, any dollar strength is inherently cyclical, not fundamental. The dollar is regularly strong, when booming domestic credit demand pills in foreign credit and capital in excess of the current account deficit. This will continue in the short term. But once the economy weakens and the financial markets falter, the dollar will plunge, as it did after 1985.

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